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U.S. ECONOMIC AND MARKET REVIEW–MARCH 2015

Markets love monetary loosening, and hate monetary tightening. As a result, so far this year U.S. equities have underperformed non-U.S. stocks, particularly European shares. For the long-term investor, however, it's important to remember *why* the U.S. is positioned to tighten, while Europe (and Japan, and others) are loosening: for all its flaws, the U.S. economy is stronger. But U.S. and other markets are also entering a stage where active investment judgment will become much more important.

In February, these comparative differences were submerged by a rising tide that momentarily lifted all equity markets. European stocks continued to soar, U.S. shares rebounded, and several emerging markets that had been stumbling got a new shot in the arm:

	JANUARY	**FEBRUARY**	YTD
S&P 500	-3.10%	**5.50%**	2.20%
Euro Stoxx 50	6.50%	**7.40%**	14.40%
FTSE 100	2.80%	**2.90%**	5.80%
Nikkei 225	1.30%	**6.40%**	7.70%
MSCI China	0.30%	**5.30%**	5.60%
MSCI India	7.20%	**4.30%**	11.80%
MSCI Brazil	-6.20%	**3.10%**	-3.30%
MSCI Russia	-1.90%	**21.30%**	19.00%
MSCI WORLD	-2.50%	**6.70%**	4.00%

The rebound in U.S. share prices was due in large part to the price of oil stabilizing, at least for the moment. No one can be sure whether oil has reached its true bottom, but its recovery to $60/barrel (Brent price) put a halt to what, in January, was starting to look like an unnerving free fall. A firmer price, even over the short run, provides a firmer foundation for assessing the damage to energy sector earnings and to oil-driven jobs and capital investment, as well as for realizing the potential benefits of cheaper energy. The stampede away from energy-related sectors has likely opened up much-needed value opportunities in the market, although investors who seize them need to be willing to ride out a roller coaster that may not be quite over.

Consensus U.S. earnings expectations for Q1 and Q2 remain deeply negative (as low as -5% y/y for both), but the economic data tells a more encouraging story. Q4 GDP was revised downward, from 2.6% to 2.2%, but mainly due to a reduction in excessive inventory accumulation; business investment, the growth factor most sensitive to future expectation, was

revised upwards, from +2.3% to +4.5%. Despite the shock to the oil-drilling sector, the U.S. economy continues to add jobs at a solid pace: 295,000 in February, bringing the unemployment rate down to 5.5% (the lowest since May 2008). The Federal Reserve, both in its Beige Book and in Janet Yellen's latest testimony to Congress, has been unambiguous in its view that the U.S. economy is steadily improving. Yet there are clearly soft spots. The ISM Manufacturing Index for February, while still "expanding" at 52.9, has fallen steadily from 57.6 in November. The new order sub-index fell to 52.5, its lowest rate of expansion since May 2013, down sharply from its blistering pace of 62.1 in November. Factory orders in January were down -2.3% from a year before. The housing market remains tepid. Consumer confidence retrenched a bit in February, after hitting a post-crisis peak in January. So far, at least, Americans have tended to save rather than spend the "windfall" they've received from lower oil prices, with retail sales and auto sales both showing declines in recent months.

One headwind to U.S. growth is the strong Dollar, which reduces the value profits American companies earn overseas and makes their products less competitive, at home and abroad. The main difference between 2% and 3% GDP growth in 4Q14 was a widening U.S. trade deficit, and several of the largest U.S. firms reported significant hits to earnings from currency translation. Nonetheless, two positive implications should be kept in mind. First, the negative impact of exchange rates has been partly offset by a positive shift in the U.S. terms of trade (the real price of imports versus exports) due in large part to cheaper oil. Second, it is important to recognize why the Dollar has been strengthening: the U.S. is the only major developed economy strong enough to even consider returning to "normal" (above-zero) interest rates.

That's important to keep in mind when considering Europe. Quantitative easing (QE) by the ECB is having an undeniable effect on markets, by lowering interest rates (which boosts bond prices and equity multiples) and weakening the Euro (which boosts the exports and overseas earnings of European companies). The "resolution" of the latest Greek crisis boosted confidence. But the Greek crisis wasn't actually resolved (Greece must enact renewed and deeply unpopular austerity measures to receive the funds it needs to avoid a looming default), and it is far from clear whether QE can resuscitate Europe's domestic economy (as opposed to tapping into external demand). Of course, one can talk fundamentals until one is blue in the face, and it may not matter–for a while, at least–so long as the central bank is opening the taps and pumping in money. However, as with Japan's QE-induced boom in share prices–there can be a substantial difference between nominal and real gains when those gains are driven by devaluing the currency. For a U.S. investor, the Euro Stoxx 50 rose just +6.0% YTD (not +14.4%) in Dollar terms, and it actually fell in January–unless you also shorted the Euro. By the same token, an unhedged Eurozone investor saw the S&P 500 rise +10.8% (not +2.2%) in Euro terms. The gap in real returns this year, between Europe and the U.S., is not nearly as great as it appears.

As for emerging markets, February's gains were a mix of credible belief (India), a desperate need to believe (China), stabilizing oil prices (Russia), and the expectation that plentiful liquidity, will help smooth out the wrinkles that remain. But ready flows of capital should not obscure the point that we have made repeatedly: that the divergent paths of emerging markets make it impossible it throw them into the same bucket and call it a strategy. There once was a time when emerging markets moved together, but now they are being pulled in different directions.

Some have trade deficits, others have trade surpluses. Some are tied to China, others to the U.S. Some are commodity exporters, others commodity importers. Some are making progress on much-needed reforms, and others are regressing. Even within countries, growth is shifting gears and creating big winners and losers. It's an investing environment that calls for active management, not passive allocation.

The U.S. is also entering a more mature bull market, where performance trumps enthusiasm. We are likely to find that earnings growth–and market returns–becomes more concentrated in fewer companies that are best positioned to navigate the shifting currents. Far from a rising tide lifting all boats (as February's gains might suggest), it will be "sink or swim". Again, this is an environment where active stock-picking (for equities) and credit analysis (for fixed income) will rise to the fore.

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